

## Message Text

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ACTION EUR-12

INFO OCT-01 NEA-10 ISO-00 AID-05 CEA-01 CIAE-00 COME-00

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TRSE-00 LAB-04 SIL-01 SAM-01 OMB-01 DODE-00 PM-04

H-02 L-03 NSC-05 PA-01 PRS-01 SS-15 USIA-06 /097 W

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FM USMISSION EC BRUSSELS

TO SECSTATE WASHDC 631

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AMEMBASSY JIDDA

C O N F I D E N T I A L EC BRUSSELS 2066

FIRST OF TWO TELEGRAMS

E.O. 11652: GDS

TAGS: EFIN, EEC

SUBJECT: EC MONETARY COMMITTEE - SEVERE ECONOMIC POLICY CONDITIONS  
PROPOSED FOR ITALY BEFORE MAKING NEW EC LOAN

REF: EC BRUSSELS 1911, EC BRUSSELS 1627, 75 EC BRUSSELS 10804

1. BEGIN SUMMARY. THE EC MONETARY COMMITTEE HAS REPORTEDLY PROPOSED ESTABLISHING MUCH STRICTER ECONOMIC POLICY CONDITIONS FOR ITALY BEFORE THE EC GOES AHEAD WITH A \$1 BILLION LOAN TO ITALY. WITHOUT RESTRICTIVE MEASURES THE COMMITTEE IS AFRAID THAT THE ADDITIONAL FUNDS WOULD BE WASTED. AS A RESULT, THE COMMISSION WAS ASKED TO DRAW UP REVISED CEILINGS FOR MONEY SUPPLY EXPANSION, THE TREASURY DEFICIT, AND CENTRAL BANK DEFICIT FINANCING. COMMISSION OFFICIALS INDICATE THAT THEY HAVE COMMITMENTS TO FINANCE ABOUT 75-80 PERCENT OF THE \$1.3 BILLION EC BORROWING ON CPAITAL MARKETS FOR IRELAND AND ITALY. SOME MEMBER STATES, HOWEVER, CONTINUE TO INSIST ON ONLY BORROWINGS WITH FIXED INTESTST RATES. END SUMMARY.

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2. CONCERN OVER ITALIAN PROSPECTS: EC COMMISSION AND OTHER OFFICIALS

BRIEFED US ON THE RESULTS OF THE FEB 27 EC MONETARY COMMITTEE MEETING IN BRUSSELS. THE COMMITTEE RECOMMENDED TO THE FINANCE COUNCIL THE ESTABLISHMENT OF MUCH MORE RESTRICTIVE ECONOMIC POLICY CONDITIONS FOR THE PROPOSED \$1 BILLION EC LOAN TO ITALY THAN WERE ORIGINALLY ADOPTED BY THE COMMITTEE IN NOVEMBER (SEE 75 BRUSSELS 10804). THE COMMITTEE'S WORKING GROUP HAD DEVELOPED WITH GOI AUTHORITIES REVISED POLICY CONDITIONS. THESE CONDITIONS WOULD HAVE MODESTLY REDUCED THE CEILINGS ON THE TREASURY DEFICIT AND MONETARY FINANCING OF THE DEFICIT. THE COMMITTEE, HOWEVER, CONSIDERED THESE PROPOSALS TO BE INADEQUATE IF ITALY'S ECONOMY WAS TO AVOID SHARP PRICE INFLATION, A BOP DEFICIT AND FURTHER DEPRECIATION OF THE LIRA THIS YEAR. WE ARE SENDING BY SEPTLE THE COMMITTEE'S ASSESSMENT OF THE ITALIAN ECONOMIC SITUATION.

3. POLICY CONDITIONS: THE COMMITTEE RECOMMENDED A NUMBER OF POLICY CONDITIONS OF WHICH THE FOLLOWING ARE THE MAIN ONES: (A) MONEY SUPPLY EXPANSION (I.E., M-2) SHOULD NOT EXCEED THE NOMINAL GROWTH OF THE GNP CORRECTED FOR THE BOP DEFICIT; IN 1975 THE NOMINAL GNP GREW BY 15.6 PERCENT WHILE THE MONEY SUPPLY ROSE BY 21.5 PERCENT; THIS YEAR THE NOMINAL GNP IS ESTIMATED TO RISE BY 16-18 PERCENT, WHICH WOULD BE THE APPROXIMATE LIMIT ON MONEY SUPPLY GROWTH; (B) THE COMMITTEE CALLED FOR A SHARP REDUCTION IN THE TREASURY DEFICIT; THE CURRENT 1976 CEILING IS 14.8 TRILLION LIRA; (C) THE CEILING FOR MONETARY FINANCING OF THE TREASURY DEFICIT - CURRENTLY SET AT 5.7 TRILLION LIR FOR 1976 - SHOULD ALSO BE REDUCED; AND (D) THE COMMITTEE ALSO SUGGESTED THAT THE GOI ADOPT AN INCOMES POLICY, OR ABOLISH THE AUTOMATIC ESCALATOR IN WAGE CONTRACTS OR BOTH SO AS TO MODERATE WAGE INCREASES. THE COMMISSION WILL NOW DRAW UP SPECIFIC CEILINGS WHICH THE FINANCE COUNCIL WILL TAKE UP AT ITS MARCH 15 MEETING.

4. SANCTIONS: FRG, TUTCH AND BELGIAN MONETARY COMMITTEE REPRESENTATIVES LED THE CRITICISM OF THE GOI'S ECONOMIC POLICIES. THEY EXPRESSED CONCERN THAT WITHOUT EFFECTIVE MANAGEMENT THE FUNDS FROM THE PROPOSED EC LOAN WOULD BE LOST THROUGH GOI INTERVENTIONS

ON THE EXCHANGE MARKETS. THEY CALLED FOR SANCTIONS TO INSURE THAT THE GOI MET THE PRESCRIBED CONDITIONS. THE COMMITTEE WOULD PREFER  
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TO ESTABLISH CONDITIONS UNDER WHICH THE EC LOAN TO ITALY WOULD BE PAID OUT IN TRanches. BUT, THIS WOULD BE DIFFICULT TO IMPLEMENT BECAUSE THE FUNDS WOULD BE BORROWED IN A RELATIVELY SHORT SPAN OF TIME. WE ARE TOLD THAT THE FRG REPRESENTATIVE (WEBER) IMPLIED THAT THE OUTSTANDING FRG GOLD COLLATERAL LOAN TO ITALY MIGHT NOT BE RENEWED IF THE GOI FAILED TO MEET THE POLICY CONDITIONS. OTHERS SUGGESTED ESTABLISHING EARLY REPAYMENTS REQUIREMENTS IN CASE THE CONDITIONS WERE NOT MET. COMMISSION OFFICIALS INDICATE,

HOWEVER, THAT THESE SANCTIONS WOULD BE DIFFICULT TO ENFORCE IN CIRCUMSTANCES IN WHICH ITALY FACED A SERIOUS FOREIGN EXCHANGE CRISIS AND IT HAD NO OTHER SOURCE OF FINANCING.

5. EXCHANGE RATE POLICY: OUR SOURCES ADD THAT THE COMMITTEE WAS DIVIDED OVER HOW THE GOI MIGHT MANAGE ITS EXCHANGE RATE POLICY. THE FRENCH AND OTHER REPRESENTATIVES EXPRESSED CONCERN THAT FURTHER LIRA DEPRECIATION WOULD MAKE ITALIAN GOODS TOO COMPETITIVE VIS-A-VIS OTHER MEMBER STATE EXPORTS. OTHER REPRESENTATIVES, HOWEVER, THOUGHT THAT IN ORDER TO AVOID SUBSTANTIAL LOSSES IN ITS RESERVES THE GOI SHOULD NOT STRONGLY RESIST MARKET PRESSURES. THE GOI REPRESENTATIVE (APLUMBO) SAID THE GOI WOULD FOLLOW AN "ELASTIC" INTERVENTION POLICY WHICH WOULD AIM AT SMOOTHING OUT ERRATIC FLUCTUATIONS WITHOUT RESISTING STRONG MARKET TRENDS. COMMISSION OFFICIALS BELIEVE THAT THE GOI WILL LET THE LIRA RATE MOVE SHOULD IT BECOME TOO EXPENSIVE TO MAINTAIN A SPECIFIC TARGET RATE.

6. SEVERE CRITICISM: COMMISSION AND OTHER OFFICIALS SAY THAT THE COMMITTEE'S CRITICISM OF ITALIAN ECONOMIC POLICIES WAS THE SEVEREST THAT THEY HAD HEARD IN THE MONETARY COMMITTEE. THEY ADD THAT THE MONETARY COMMITTEE OPERATES AT A TECHNICAL LEVEL AND ONCE POLITICAL CONSIDERATIONS ARE TAKEN INTO ACCOUNT, THE FINANCE COUNCIL MAY DECIDE TO EASE THE PROPOSED POLICY CONDITIONS FOR ITALY. THE COMMITTEE RECOGNIZES THAT THE GOI ITSELF MUST TAKE THE POLITICAL DECISION TO ESTABLISH AN INCOMES POLICY OR ELIMINATE ESCALATION CLAUSES IN WAGE CONTRACTS. THE COMMITTEE CONCLUDED BY RECOMMENDING THAT THE EC SHOULD GRANT A LOAN TO ITALY AS LONG AS THE GOI AGREES TO THE PROPOSED CONDITIONS.

7. AVAILABILITY OF FUNDS: COMMISSION OFFICIALS TOLD THE COMMITTEE THAT THE SAUDI ARABIAN MONETARY AGENCY HAD NOT YET RESPONDED TO THEIR QUERIES REGARDING A \$300 MILLION EC BORROWING FOR  
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IRELAND (SEE FIRST TWO REFS). THE COMMISSION ASSUMES THAT SAUDI ARABIA IS NO LONGER INTERESTED IN A LOAN TO THE EC. THUS, THE BORROWING FOR IRELAND WOULD HAVE TO BE ADDED TO THE ONE FOR ITALY MAKING THE TOTAL PLACEMENT ON CAPITAL MARKETS \$1.3 BILLION. THE COMMISSION HAS REPORTEDLY RECEIVED COMMITMENTS FOR 75-80 PERCENT OF THIS AMOUNT. IT HOPES TO BE ABLE TO RAISE THE BALANCE BEFORE THE MARCH 15 COUNCIL MEETING. OVERALL THE AVERAGE MATURITY PERIOD WOULD BE ABOUT FIVE YEARS.

8. VARIABLE VS FIXED INTEREST RATES: THE FRG AND DUTCH REPRESENTATIVES WERE ADAMANT THAT THE EC UNDERTAKE ONLY BORROWINGS WITH FIXED INTEREST RATES. AS A RESULT, THE COMMISSION PROPOSED THE FOLLOWING BORROWING COMBINATION: (1) \$300 MILLION ON THE EUROBOND MARKET AT SIX YEARS; (2) THE EQUIVALENT OF \$200 MILLION IN DM ON THE GERMAN MARKET AT SIX YEARS; (3) ABOUT \$500 MILLION

WORTH OF 3.5-YEAR NOTES ON THE EUROCURRENCY AND PERHAPS US  
MARKETS; AND (4) THE BALANCE ON THE EUROCURRENCY MARKET AT  
VARIABLE INTERST RATES. A SPECIAL WORKING GROUP WILL PREPARE A  
FINAL PROPOSAL FOR THE FINANCE COUNCIL ON MARCH 15. HINTON

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